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Supreme Court of the United States.

OCTOBER TERM, 1967.

No. 1067

KNAPP BROTHERS SHOE MANUFACTURING CORPORATION,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

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Supreme Court of the United States.

OCTOBER TERM, 1967.

No.

KNAPP BROTHERS SHOE MANUFACTURING CORPORATION,
Petitioner,
v.
UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

Petitioner, Knapp Brothers Shoe Manufacturing Corporation, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the First Circuit entered in the above-entitled case on November 2, 1967. The decision below presents important questions of federal law which have not been, but should be, decided by this Court, and is essentially in conflict with a decision of the Court of Claims.

Opinions Below.

The opinion of the United States District Court for Massachusetts holding in favor of petitioner is reported at 265

F. Supp. 133, and is reprinted in Appendix A hereto. The opinion of the Court of Appeals reversing the judgment of the District Court is reported at 384 F. 2d 692, and is reprinted in Appendix B hereto.

Jurisdiction.

The judgment of the Court of Appeals was entered on November 2, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented.

Is a corporate taxpayer to be denied an otherwise allowable federal income tax deduction for voluntary charitable contributions to a qualified educational institution on the sole ground that the corporation's certificate of incorporation provides that distributions of its net income or other assets may be made only to that particular educational institution, where the institution did not organize and neither owns nor controls the corporation?

Statutes and Rules Involved.

The statutory provisions involved are Sections 11, 170(a) and (b)(2), and 502 of the Internal Revenue Code of 1954 (26 U.S.C.) reprinted in pertinent part in Appendix C hereto.

Statement of the Case.

The Court of Appeals for the First Circuit reversed the judgment, in favor of the petitioner, of the United States

District Court for the District of Massachusetts in an action brought to recover overpayments of federal corporation income taxes for petitioner's fiscal years ended March 31, 1957, through March 31, 1960, arising from the disallowance of petitioner's deduction of, and its claims for refund based upon, certain portions of larger payments made in each of these years as charitable contributions. Jurisdiction of said District Court was conferred by 28 U.S.C. § 1346(a)(1).

Petitioner is a Delaware corporation, organized on March 13, 1948, having its principal place of business in Brockton, Massachusetts, and engaged principally in the manufacture and sale of shoes. On March 31, 1948, it acquired from the owners, Clarence E. Knapp and Elwin D. Knapp, all the stock of Knapp Brothers, Inc., for a total consideration of $5,100,000. On the same day four other corporations, wholly owned subsidiaries of Knapp Brothers, Inc., were merged into petitioner.

Petitioner was formed by three New York lawyers, each then an alumnus of or graduate student at New York University (the "University"), who contributed the initial capitalization of $1,000. Their purpose in forming the corporation was to make sums available, in the discretion of its directors, for the educational purposes of New York University, but they claimed no tax deduction for their capital contributions. It was the intention of the parties, which was in fact carried out, that the $5,100,000 purchase price would be paid to the Knapps out of the earnings of the corporation.

The petitioner's certificate of incorporation contains the following pertinent provisions (Record Appendix 13a, 17a):

> "THIRD: . . . no part of its income or property shall inure to the private benefit of any stockholder, director, or officer, or any individual or corporation

other than New York University. The directors shall from time to time distribute to New York University such part of the property and/or net income of the Foundation as they may determine and as may legally be distributable.

"FOURTH: The objects for which the Foundation is formed are:

"(a) To distribute to New York University such part of its property and/or its net income, as the directors of the Foundation may determine.

. . . . . .

"NINTH: . . .

. . . . . .

"(h) No stockholder shall at any time be entitled to dividends on his shares; nor shall he at any time be entitled to any of the profits or assets of the Foundation. The profits or assets of the Foundation available for distribution shall be paid from time to time, at the discretion of the directors, to New York University; and in the event of the liquidation, dissolution, or winding up of the Foundation, whether voluntary, involuntary or by operation of law, except as may otherwise be provided by law, the directors of the Foundation shall, after payment of all creditors, distribute the assets of the Foundation to New York University."

On April 1, 1948, the stockholders of petitioner transferred all of its stock to themselves as trustees of a so-called voting trust for a period of ten years, which was extended in 1957 for a further term of ten years (Stip. Exs. 10 and 12, Record Appendix 20a-27a). The trust provides, *inter alia*, that the trustees have *both* the beneficial ownership of and legal title to the stock; that the trust may be ex-

tended and re-extended indefinitely by the shareholder-trustees, acting alone; and that, four months after the termination of the last extension thereof, the stock is to be transferred to New York University (*ibid.*).

In the tax years involved here petitioner paid the following amounts to New York University and to New York University-Bellevue Medical Center (a separate administrative unit of the University) as charitable contributions:

Year Ending	University	Center
March 31, 1957	$600,000	$100,000
March 31, 1958	50,000	100,000
March 31, 1959	150,000	100,000
March 31, 1960	150,000	100,000

In determining the amount of these payments, the directors took into account the high profitability of the petitioner and the amount of its assets available for contributions after provision for its foreseeable needs (Transcript, Record Appendix 63a, 70a). During these years the petitioner also made other contributions, concededly deductible, in relatively small amounts to charities in the areas where its factories are located.

As found by the District Court below, on the basis of uncontroverted evidence:

> "Neither New York University, nor any of its officers, trustees or employees had any part in the organization of plaintiff or provided any of its capital. The University has never owned any stock in the plaintiff. Since the organization of plaintiff no director, officer, trustee or employee of plaintiff has ever been an officer, trustee or employee of the University. The University has never participated in any way in the selection of the voting trustees or of plaintiff's di-

rectors or officers. No trustee, officer or employee of the University has ever participated in, influenced or attempted to influence, or consulted with the plaintiff's directors in connection with the conduct of plaintiff's affairs. No trustee, officer or employee of the University has ever directed plaintiff to make a contribution to it, or requested such a contribution, and plaintiff's directors have never consulted with the University as to what contributions should be made.

. . . . . .

"Each of these payments was voted or ratified by plaintiff's directors as a charitable contribution. None of the directors considered that there was any obligation to make any particular payment. The recipients treated the payments received as charitable contributions."

During the years in question New York University and the Medical Center were educational organizations of the type described in Section 170(c) (2) of the Internal Revenue Code of 1954, and were ruled to be such by the Internal Revenue Service. See IRS Pub. No. 78 (Rev. 12-66). Petitioner claimed as deductions for charitable contributions the following amounts of its total payments to the University and the Medical Center:

Year	Amount Deducted
1957	$100,000.00
1958	102,337.87
1959	98,383.14
1960	110,079.29

These deductions were disallowed and, after payment of the tax deficiencies thereafter assessed, petitioner filed

claims for refund aggregating $243,838.90, plus interest. These claims were disallowed by the Internal Revenue Service in their entirety.

This suit followed. After trial, the District Court entered a judgment in favor of the petitioner in the amount of $243,838.90 in tax and $58,703.10 in assessed interest, for a total of $302,542.00, with interest thereon and costs. On appeal, this judgment was reversed.

Petitioner is subject to federal income taxation under Section 11 of the Internal Revenue Code of 1954 in the same manner and to the same extent as is every other domestic business corporation, and is entitled to no special exemption or other privilege (see Section 502, Internal Revenue Code of 1954).

Argument.

1. The Decision Below is Essentially in Conflict with a Decision of the Court of Claims.

In *SICO Foundation* v. *United States,* 295 F. 2d 924 (Ct. Cl. 1961), the Court of Claims allowed, as "clearly" deductible, contributions to public schools in Pennsylvania made by a Delaware charitable corporation organized to conduct a trade or business, the profits from which were to be used exclusively for educational purposes through distributions to such schools. There is no logical or rational basis for any distinction between corporations (like petitioner) dedicated to a single charity and those dedicated to a group or class of charities, and any such distinction would be flatly contrary to the very language of Section 502, making that Section applicable to corporations the profits of which "are payable to *one or more* organizations exempt under Section 501 from taxation." [Emphasis added.] Accordingly, there is a conflict between the

decision of the Court of Appeals for the First Circuit, in the present case, and the decision of the Court of Claims, in the *SICO* case, which conflict relates to an important question of federal law and can only be resolved by this Court. See *United States* v. *Consolidated Edison Co. of New York, Inc.*, 366 U.S. 380, 381 (1961).

2. The Decision of the Court of Appeals Below Poses a Direct Challenge to Long-Established Patterns of Charitable Giving and to Clear Congressional Policy to Encourage Charitable Donations.

The Court of Appeals below held that a deduction for a charitable donation, otherwise clearly deductible, by a business corporation to an unrelated tax-exempt educational institution is to be denied, solely for the reason that that institution is the entity which, under that corporation's charter, is the only permitted recipient of any assets or net earnings which the corporation's board of directors may elect to distribute. By this decision, then, a business enterprise whose assets and earnings, if distributed, are dedicated to the exclusive benefit of a single, but unrelated, charity is to be put in a materially worse position in the case of a contribution to that charity than a business enterprise dedicated to general charitable purposes, or even to the benefit of a small group or class of charities, would be if it made such a contribution. The implications of such a holding to private philanthropy are far reaching.

The right of a donor to place property in trust for the benefit of a single operating charity, but under the control and management of trustees wholly independent of the governing body of such charity, is well established and has been jealously guarded by the courts. See *Winthrop* v. *Attorney General*, 128 Mass. 258 (1880), in which the Massa-

chusetts Supreme Judicial Court refused to permit trustees, to whom property had been donated for the benefit of Harvard College, to enter into an agreement whereby such property would be taken over and managed by the College itself. The Court there stated, at page 260:

> "It seems to us clear that this agreement is inconsistent with the terms of the trust. It was plainly the intention of the donor to entrust the large sum given by him to the care and management of the trustees chosen by him, and their successors. He selected as trustees men of ability and eminence, and carefully provided that they should be succeeded by men of like character."

More recently, and in particular since the end of World War II, many gifts of property for charitable uses and purposes have consisted of the stock or assets of business corporations. Donors have found that the gift to a charitable or educational institution of a profitable operating business can be far more productive of income for the institution than a cash contribution which is either expended currently or added to an endowment fund that has a relatively low return on investment. The case here presented is a spectacular example of success for this form of investment. In only twenty years the sum of $1,000 invested by the donors in a going business has resulted in contributions to New York University of the total sum of $5,050,000 while, at the same time, the corporation has grown from a net worth of approximately $2,000,000 to a net worth in excess of $18,000,000. New York University will continue to benefit from the earnings of this expanded business enterprise and will receive the value of the assets if the business is sold or liquidated.

Charitable and educational institutions have been advised and urged to meet their chronic and continuous need for funds by innovative and enterprising forms of investment. In a recent annual report of The Ford Foundation its President, McGeorge Bundy, made the following statement:

> "The last great source of funds for American colleges and universities is the endowment fund. We believe that there may be room for great improvement here. It is far from clear that trustees have reason to be proud of their performance in making money for their colleges. We recognize the risks of unconventional investing, but the true test of performance in the handling of money is the record of achievement, not the opinion of the respectable. We have the preliminary impression that over the long run caution has cost our colleges and universities much more than imprudence or excessive risk-taking. The Foundation intends to make a careful survey of this whole field. If our first impression is even partly justified, the consequences for the welfare of the Higher Learning may be much larger than any direct grant that this foundation could possibly make. The capital portfolios of American college and universities are now estimated at $12 billion, at market value. If their current average annual performance, counting both interest and capital appreciation, could be improved by only 1 per cent of capital per year, the increased return to colleges and universities would be $120 million a year, more than twice the current budget of the Ford Foundation for Education and Research."[1]

[1] The Ford Foundation, Annual Report October 1, 1965, to September 30, 1966, VII-VIII.

It is understood that, consistently with such advice, a number of charitable and educational institutions have invested their own funds in wholly or partially owned business corporations. The decision of the Court below would preclude any tax deductions for contributions made by such a wholly owned corporation to its charitable owner since it is premised on a conclusion that New York University is the beneficial owner of the petitioner in spite of the University's absence of control or right to control either petitioner's operations or contributions.

The Congress has long permitted individual donors to make deductible contributions to charities which the donors control, and has never seen fit to legislate that donor business enterprises cannot make deductible contributions to charitable or educational institutions which control them. Whether the control rests in fact on stock ownership or, as characterized by the Court below in petitioner's case, on the beneficial ownership of the donor, if there is to be a change in policy, the change should be made by Congress and not by judicial legislation. To deny a business corporation whose earnings and assets must go to a specific charitable or educational institution a charitable deduction for gifts to that institution to the same extent permissible for any other corporation making a charitable gift to that institution is discriminatory and will result in a serious and deleterious impact on private philanthropy, on the financial management of charitable institutions, and on the public welfare. It is submitted that this matter is of sufficient national importance to require a hearing by this Court.

3. The Decision Below is in Conflict with Unequivocal Provisions of the Internal Revenue Code of 1954 and is Inconsistent with the Purpose of Congress in Enacting Said Provisions.

The decision of the Court of Appeals below is contrary to the applicable provisions of the Internal Revenue Code of 1954. Petitioner is a "feeder" corporation under Section 502 of the Code. It is plain, both from the statutory language itself and from the legislative history, that the object of Section 502 was to impose on business corporations owned by or for the benefit of charities *the same* tax as is imposed on all other business corporations.[2]

Section 502 accomplishes this result merely by denying tax *exemption* to a business organization "on the ground that all of its profits are payable to one or more organizations exempt under section 501 from taxation." Thus a corporation such as petitioner, all profits of which may be payable to an exempt organization, is subject to the *same* tax imposed on "every corporation" by Section 11 of the Code, and, we submit, is likewise entitled to all the deductions and credits allowable to other business corporations. Included among such deductions is that allowable to corporations under Section 170(b) (2) for charitable contributions. Yet the decision of the Court of Appeals below would deny any such deduction to corporations in the position of the petitioner for amounts paid by them and received by their ultimate beneficiaries as charitable contributions—amounts which, if so paid by any other corporation, would indisputably be deductible.

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[2] See H.R. Rep. No. 2319, 81st Cong., 2d Sess., p. 37, 1950-2 Cum. Bul. 380, 412; Sen. Rep. No. 2375, 81st Cong., 2d Sess., p. 35, 1950-2 Cum. Bul. 483, 509.

The Court below justified its result on the theory that any payment by petitioner to New York University is analogous to a dividend. It based this conclusion on its recent decision in *Crosby Valve & Gage Co.* v. *Commissioner*, 380 F. 2d 146 (1st Cir. 1967); cert. den. U.S. , 88 S. Ct. 477 (1967), denying a deduction for amounts paid by a business corporation to its sole stockholder, a private charitable foundation controlled by the same persons who were active in the affairs of the corporation. As the Tax Court had found below, the payments by the corporation to the foundation "were the result primarily of the control which the foundation had over [the corporation] and the 'legal duty' which [the corporation] had to carry out the will of its sole stockholder." *Crosby Valve & Gage Co.*, 46 T.C. 641 (1966), at 647. The factual differences between the *Crosby* case and the present case make *Crosby* inapposite. In the present case there is no control of the petitioner by New York University. The University's interest is solely as a passive recipient of such payments as petitioner's directors may determine, exercising their sound discretion and after considering the needs of the petitioner's business. As well stated by the District Court below:

> "It cannot be found that the University is the owner of plaintiff. In form the plaintiff is clearly a distinct entity in which the University has no right of ownership. The University's sole interest is that only the University can receive any distribution of the income or property of plaintiff, if and when such a distribution may be made, and eventually to receive the proceeds of any liquidation of plaintiff. The University had no part in the formation of plaintiff, it has no right to exercise any control over the plaintiff and its affairs, either directly or indirectly, and it has not in fact ever

exercised or sought to exercise any control or influence over plaintiff. Plaintiff is in fact as well as in form a completely independent entity. The University is the ultimate beneficiary of its activities but it cannot be called in any sense its owner.

"The University has no right to control payments the corporation may make to it, and does not in fact seek to control or influence them. The certificate of organization clearly leaves the amount and the time of any payment to the discretion of the directors of the corporation. The University has at no time a present and immediate right to any payment from the corporation. The directors may in their sound judgment retain the profits of the corporation for business expansion or other legitimate corporate purposes. Any funds not distributed to the University remain subject to the risks of a business over which the University has no control and therefore the University may never get them. The action of the directors in voting to make a payment was a free act on their part conferring on the University a financial benefit to which it had no present and immediate right and which possibly it might never receive."

The decision below is contrary to the basic objective of Congress in providing in Section 502 that every feeder corporation should be taxed just as any other business corporation and would subvert the clearly expressed Congressional policy of furthering charitable donations. It is submitted that intervention by this Court is called for to correct this error, not merely for the sake of the petitioner and other similarly situated taxpayers, but for the sake of charities which may be deprived of very substantial funds if the decision below be allowed to stand.

Conclusion.

For the reasons stated above, it is respectfully submitted that a writ of certiorari should issue to the United States Court of Appeals for the First Circuit so that the foregoing important questions relating to federal taxation may be heard.

Respectfully submitted,
ROBERT W. MESERVE,
Attorney for Petitioner.

JOHN K. P. STONE, III,
NUTTER, MCCLENNEN & FISH,
Of Counsel.

Dated: Boston, Massachusetts,
January 31, 1968.

Appendix A.

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

KNAPP BROTHERS SHOE MANUFACTURING CORPORATION, *Plaintiff* v. UNITED STATES OF AMERICA, *Defendant*	Civil Action No. 66-33-F

OPINION

March 14, 1967

FORD, D.J.

This is an action by a corporation to recover alleged overpayments of federal corporation income taxes for its fiscal years ending March 31, 1957 through March 31, 1960, arising from the disallowance of its deduction of certain payments in each of these years as charitable contributions. The resulting deficiencies were paid, claims for refund were duly filed and disallowed by defendant.

Plaintiff is a Delaware corporation organized on March 13, 1948, having its principal office in Brockton, Massachusetts and engaged in the manufacture and sale of shoes. On March 31, 1948 it acquired from the owners, Clarence E. Knapp and Edwin D. Knapp, all the stock of Knapp Brothers, Inc. for a total consideration of $5,100,000. On the same day four other corporations, wholly owned subsidiaries of Knapp Brothers, Inc., were merged into plaintiff.

Plaintiff was formed by three New York lawyers who contributed the initial capitalization of $1000. Their purpose in forming the corporation was to confer an ultimate benefit on New York University, and they considered the $1000 they paid as a contribution to the University although they claimed no tax deduction for it. It was the intention of the parties, which was in fact carried out, that the $5,100,000 purchase price would be paid to the Knapps out of the earnings of the corporation.

The plaintiff's certificate of incorporation contains the following pertinent provisions:

> "THIRD: * * * no part of its income or property shall inure to the private benefit of any stockholder, director, or officer, or any individual or corporation other than New York University. The directors shall from time to time distribute to New York University such part of the property and/or net income of the Foundation as they may determine and as may legally be distributable.
>
> "FOURTH: The objects for which the Foundation is formed are:
>
> "(a) To distribute to New York University such part of its property and/or its net income, as the directors of the Foundation may determine.
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> "NINTH: * * *
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> "(h) No stockholder shall at any time be entitled to dividends on his shares; nor shall he at any time be entitled to any of the profits or assets of the Foundation. The profits or assets of the Foundation available for distribution shall be paid from time

to time, at the discretion of the directors, to New York University; and in the event of the liquidation, dissolution, or winding up of the Foundation, whether voluntary, involuntary or by operation of law, except as may otherwise be provided by law, the directors of the Foundation shall, after payment of all creditors, distribute the assets of the Foundation to New York University."

On April 1, 1948 the original stockholders transferred all the stock of plaintiff to a voting trust for a period of ten years, later extended. The trust provides that four months after the termination of the trust or its last extension the stock is to be transferred to New York University.

Neither New York University, nor any of its officers, trustees or employees had any part in the organization of plaintiff or provided any of its capital. The University has never owned any stock in the plaintiff. Since the organization of plaintiff no director, officer, trustee or employee of plaintiff has ever been an officer, trustee or employee of the University. The University has never participated in any way in the selection of the voting trustees or of plaintiff's directors or officers. No trustee, officer or employee of the University has ever participated in, influenced or attempted to influence, or consulted with the plaintiff's directors in connection with the conduct of plaintiff's affairs. No trustee, officer or employee of the University has ever directed plaintiff to make a contribution to it, or requested such a contribution, and plaintiff's directors have never consulted with the University as to what contributions should be made.

In the tax years involved here plaintiff paid the following amounts to New York University and to New York

University-Bellevue Medical Center (a separate administrative unit of the University):

Year Ending	University	Center
March 31, 1957	$600,000	$100,000
March 31, 1958	50,000	100,000
March 31, 1959	150,000	100,000
March 31, 1960	150,000	100,000

Each of these payments was voted or ratified by plaintiff's directors as a charitable contribution. None of the directors considered that there was any obligation to make any particular payment. The recipients treated the payments received as charitable contributions. During these years the plaintiff made charitable contributions in small amounts to beneficiaries in the areas where its factories are located.

During the year in question New York University and the Medical Center were charitable organizations of the type described in § 170(c)(2) of the Internal Revenue Code of 1954. Plaintiff claimed as a deduction for charitable contributions the following amounts of its payments to the University and the Medical Center:

Year	Amount Deducted
1957	$100,000.00
1958	102,337.87
1959	98,383.14
1960	110,079.29

These deductions were disallowed and after payment of the tax deficiencies assessed, plaintiff filed claims for refund aggregating $243,838.90, plus interest. These claims were disallowed in their entirety.

The government's position is that these payments were not charitable contributions. It argues first that the court

should find that the University is in substance the owner of plaintiff corporation and cannot be entitled to a deduction for a charitable contribution to itself. It further argues that any charitable contribution must be something in the nature of a gift, and that in view of the restrictions of plaintiff's charter any payment to the University was not in any sense a gift but merely the fulfilling of a legal obligation.

It cannot be found that the University is the owner of plaintiff. In form the plaintiff is clearly a distinct entity in which the University has no right of ownership. The University's sole interest is that only the University can receive any distribution of the income or property of plaintiff, if and when such a distribution may be made, and eventually to receive the proceeds of any liquidation of plaintiff. The University had no part in the formation of plaintiff, it has no right to exercise any control over the plaintiff and its affairs, either directly or indirectly, and it has not in fact ever exercised or sought to exercise any control or influence over plaintiff. Plaintiff is in fact as well as in form a completely independent entity. The University is the ultimate beneficiary of its activities but it cannot be called in any sense its owner.

The University has no right to control payments the corporation may make to it, and does not in fact seek to control or influence them. The certificate of organization clearly leaves the amount and the time of any payment to the discretion of the directors of the corporation. The University has at no time a present and immediate right to any payment from the corporation. The directors may in their sound judgment retain the profits of the corporation for business expansion or other legitimate corporate purposes. Any funds not distributed to the University remain subject to the risks of a business over which the Uni-

versity has no control and therefore the University may never get them. The action of the directors in voting to make a payment was a free act on their part conferring on the University a financial benefit to which it had no present and immediate right and which possibly it might never receive. Such a payment qualifies as a contribution rather than a legally required payment. It is none the less a contribution because the directors could not pay the money to anyone else, so long as they were free to decide to pay it to the University or not. *SICO Foundation* v. *U.S.*, 295 F. 2d 924.

Government contends that allowance of these deductions as charitable contributions is barred by § 502 of the Internal Revenue Code which provides:

> "An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501 from taxation. For purposes of this section, the term 'trade or business' shall not include the rental by an organization of its real property (including personal property leased with the real property).

Literally this only excludes plaintiff here from the exemption provided by § 501, on which plaintiff bases no claim. There is no basis for holding, as defendant appears to argue, that because § 502 says that plaintiff is not entitled to the exemption granted by § 501, it is entitled to no exemption at all. The provisions of § 502 were first brought into the Code by the Revenue Act of 1950. Prior to that time an organization carrying on a business for profit would have all its income exempt from taxation provided all its profits were payable to a tax-exempt charitable organiza-

tion. Plaintiff indeed appears to have been originally organized in the way it was to take advantage of that exemption and was in fact held entitled to it. *Knapp Brothers Shoe Manufacturing Corp.* v. *United States,* 142 F. Supp. 899. The purpose of Congress in enacting the provision now found in § 502 was to terminate the complete tax exemption of such business because it was felt that it was thereby being given an unfair competitive advantage over competitors organized for private profit. In order to attain the purpose of § 502 it is not necessary to go beyond what it literally requires to deny plaintiff the exemption it claims here. Plaintiff here is now subject to taxation on its income in the same manner as its competitors operating for private profit. Those competitors would clearly be entitled to claim a tax deduction within the limitation of § 170(b)(2) for a contribution to New York University or any other properly qualified charitable organization. Plaintiff should equally be entitled to it. To say that it cannot claim a deduction for its payments to New York University because it was organized for the specific purpose of benefiting New York University and cannot distribute its profits to other beneficiaries would be to go beyond the purpose of § 502 and place plaintiff in a worse tax position than its competitors.

Judgment will be entered for plaintiff in the amount of $243,838.90 with interest and costs.

Appendix B.

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 6955.

UNITED STATES OF AMERICA,
DEFENDANT, APPELLANT,
v.
KNAPP BROTHERS SHOE MANUFACTURING CORPORATION,
PLAINTIFF, APPELLEE.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS
[265 F.SUPP. 133]

Before ALDRICH, *Chief Judge,*
McENTEE and COFFIN, *Circuit Judges.*

Albert J. Beveridge, III, Attorney, Department of Justice, with whom *Mitchell Rogovin,* Assistant Attorney General, *Meyer Rothwacks* and *Harry Baum,* Attorneys, Department of Justice, *Paul F. Markham,* United States Attorney, and *Joseph A. Lena,* Assistant U.S. Attorney, were on brief, for appellant.

Robert W. Meserve, with whom *John K. P. Stone, III,* and *Nutter, McClennen & Fish* were on brief, for appellee.

November 2, 1967.

ALDRICH, *Chief Judge.* In 1948 three individuals interested in New York University, a recognized charitable organization within the federal income tax statute, now Int. Rev. Code of 1954, § 170(c)(2), formed taxpayer, Knapp Brothers Shoe Manufacturing Corporation. The certificate

of incorporation was peculiar in that it provided, "No stockholder shall at any time be entitled to dividends on his shares; . . . [or] to any of the profits or assets. . . ." The sole distributee of both income and property, irrevocably in perpetuam, was New York University. The only limitation upon the University's interest was the immediate one that, since it was not a stockholder,[1] and therefore had no voting rights, or share in the management, it had no say as to when or what distributions should be made.

Upon its formation taxpayer acquired all of the assets of Knapp Brothers, Inc., a successful shoe manufacturer, the purchase price to be paid out of earnings. The business continued to be profitable and during the taxable years 1957-1960 taxpayer made substantial payments to the University which it labelled in giving, and the University labelled in receiving, "contributions." The issue is whether these payments are to be regarded in law as charitable contributions for which, up to the 5% limitation in section 170(b)(2), taxpayer could take a deduction against gross income. The district court held for the taxpayer. Thereafter we decided *Crosby Valve & Gage Co.* v. *Commissioner,* 1 Cir., 1967, 380 F.2d 146, in favor of the government. The question now before us is whether taxpayer can escape the ambit of that case.

In *Crosby Valve* the taxpayer, a business corporation like the present taxpayer, was wholly owned by a charitable foundation. It made periodic payments to the charity which we found fell "equally within the literal meanings of 'charitable contribution' under section 170(c) of the Internal Revenue Code, and of 'dividend' under section 316

[1] The stock is presently held in a voting trust, in which the University does not participate. Concededly the trust effected no substantive change so far as the University's interest was concerned.

(a)." 380 F.2d at 147. Thus unable to define the payments for tax purposes from a literal reading of the two sections, we sought Congressional purpose through an evaluation of the overall statutory treatment of charitable organizations. We concluded that in this respect Congress intended to place charitably-owned businesses which were not themselves charities on the same footing as their noncharitable competitors, as evidenced by the feeder organization and unrelated business income provisions of the 1954 Code, sections 502, 511-515, and that we must select against the taxpayer to prevent its enjoying an advantage over its competitors contrary to the purpose of the act.

> "[W]ere petitioner's deductions to be allowed it would be able to make a partially tax-free distribution of its earnings to its sole stockholder—something denied to its competitors and clearly contrary to the approach to the tax treatment of 'feeder' organizations taken by section 502 of the Internal Revenue Code." 380 F.2d 149.

In the case at bar taxpayer argues that the University is neither "owner" nor "shareholder," and that the *Crosby Valve* rationale is therefore inapplicable. "[T]he *owners* of appellee," it urges, "are the voting trustees, who, under the voting trust instruments, are vested with both legal and beneficial ownership of the stock. The University is a beneficiary, if at all, only in the narrow sense of being entitled to any corporate profits or assets when and if the voting trustee-elected directors choose to bestow them." We cannot agree. In fact, we would describe the substance of the situation as precisely the reverse. It is the University which possesses the real beneficial interest. It is the stockholders group that "is a beneficiary, if at all, only in the narrow sense," viz., of being entitled to choose when to

bestow the profits. They neither have nor can have any interest or purpose apart from the ultimate interest of the University.[2]

Taxpayer argues that the University may never receive any funds from it; that the stockholders may retain all profits in the company, and the company, instead of succeeding, may go bankrupt. Initially this overlooks the fact that the University has already received the substantial profits which are presently involved. More fundamentally, if it never receives further payments it will be because there are no profits or assets to distribute, not because they are distributable to someone else. The possibility that no one will benefit from the operations of the taxpayer does not alter the fact that if any profits do become payable, they are payable to the University.[3]

This conclusion is not at variance with the fact that taxpayer, like any business corporation, may make limited charitable contributions within its community, large or small as it views it, by virtue of section 170(b)(2). In enacting this statute we believe that Congress recognized that good citizenship and charitable giving were, to put it

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[2] The interest of the stockholders as holders of the *legal* title is even less "adverse" to the University than that of the ordinary inter vivos trustee whose consent is required to exercise a power of termination. *Cf. New England Merchants Nat'l Bank* v. *United States,* 1 Cir., 10/17/67. In the usual trust, postponement of termination may result in the ultimate appearance of new beneficiaries. Here, the interest of the University in the property can never be terminated.

[3] In a very real sense, accordingly, taxpayer falls within the language, as well as the intent, of section 502 (a "business for profit . . . all of [whose] . . . profits are payable to one or more organizations exempt under section 501 from taxation.") upon which we relied in deciding *Crosby Valve.*

bluntly, good business.[4] Charity that begins at home, however "amiable,"[5] is not within that concept. We see no reason why taxpayer should escape this fact any more than *Crosby Valve.*

The judgment of the District Court is reversed and judgment is ordered for the defendant.

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[4] Even prior to the first enactment of a charitable deduction provision for corporations in 1935 (ch. 829, 49 Stat. 1014), corporations were permitted deductions for "donations which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its business." Reg. 74, Art. 262, quoted in *Chicago & N.W. R. Co.* v. *Commissioner,* 7 Cir., 1940, 114 F.2d 882, 888. The expanded recognition of the close relationship between the warm heart and cool head of business is seen in now Int. Rev. Code of 1954, § 162(b), which disallows the section 162(a) "ordinary and necessary" business expense deduction "for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section." See discussion in *Citizens & Southern Nat'l Bank of S.C.* v. *United States,* W.D. S.C., 1965, 243 F.Supp. 900.

[5] *The School for Scandal,* Act V, Sc. 1.

Appendix C.

Statutes and Rules Involved.

Internal Revenue Code of 1954.

Sec. 11. Tax Imposed.

(a) Corporations In General.—A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

. . . . . .

Sec. 170. Charitable, Etc., Contributions and Gifts.

(a) Allowance of Deduction.—

(1) General Rule.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary or his delegate.

. . . . . .

(b) Limitations

. . . . . .

(2) Corporations.—In the case of a corporation, the total deductions under subsection (a) for any taxable year shall not exceed 5 percent of the taxpayer's taxable income computed without regard to—

(A) this section,

(B) part VIII (except section 248),

(C) any net operating loss carryback to the taxable year under section 172, and

(D) section 922 (special deduction for Western Hemisphere trade corporations).

Any contribution made by a corporation in a taxable year (hereinafter in this sentence referred to as the "contribution year") in excess of the amount deductible for such year under the preceding sentence shall be deductible for each of the 5 succeeding taxable years in order of time, but only to the extent of the lesser of the two following amounts: (i) the excess of the maximum amount deductible for such succeeding taxable year under the preceding sentence over the sum of the contributions made in such year plus the aggregate of the excess contributions which were made in taxable years before the contribution year and which are deductible under this sentence for such succeeding taxable year; or (ii) in the case of the first succeeding taxable year, the amount of such excess contribution, and in the case of the second, third, fourth, or fifth succeeding taxable year, the portion of such excess contribution not deductible under this sentence for any taxable year intervening between the contribution year and such succeeding taxable year.

SEC. 502. FEEDER ORGANIZATIONS.

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501 from taxation. For purposes of this section, the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Appendix D.

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 6955.

UNITED STATES OF AMERICA,
Defendant, Appellant,
v.
KNAPP BROTHERS SHOE MANUFACTURING CORPORATION,
Plaintiff, Appellee.

JUDGMENT

November 2, 1967

This cause came on to be heard on appeal from the United States District Court for the District of Massachusetts, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The judgment of the District Court is reversed and judgment is ordered for the defendant.

By the Court:

ROGER A. STINCHFIELD, Clerk.
By: /s/ DANA H. GALLUP
Chief Deputy Clerk.